Internal Revenue Service

memorandum

CC:TL:Br2
SJHankin

date: JUL 25 1986

to: District Counsel, Atlanta CC:ATL

from: Director, Tax Litigation Division CC:TL

subject: Applicability of Treas. Reg. Section § 1.338-IT(1)(2)(ii)--
[redacted]

This memorandum is in response to your written request for technical advice, dated April 24, 1986.

ISSUE

Whether the transitional rules of Treas. Reg. § 1.338-IT(1)(2) require [redacted] (old target) to file a separate one day return reporting the recapture taxes resulting from a section 338 election to treat the stock purchase as an asset purchase.

Specifically, whether the "clear and convincing evidence" requirement of Treas. Reg. § 1.338-IT(1)(2) is not satisfied, because of a provision in the original purchase agreement, whereby the purchaser [redacted] promised to indemnify and hold harmless the selling group against any tax liabilities they might incur as a result of a section 338 election made by the purchaser.

CONCLUSION

We conclude that the indemnity provision of Treas. Reg. § 1.338-IT(1)(2) (ii) is a valid interpretation of the statute in question, i.e., section 306(a)(8)(A)(ii) of the Technical Correction Act (TCA) of 1982. Moreover, we conclude that the indemnification clause of Treas. Reg. § 1.338-IT(1)(2)(ii) is applicable in this case to the original stock purchase agreement entered into on [redacted] between the parties. Accordingly, we conclude that [redacted] should be required to file a separate one day return reporting the recapture taxes resulting from [redacted]'s section 338 election.

FACTS

We incorporate, herein by reference, the facts you provided to this office in your memorandum, dated April 24, 1986.

DISCUSSION

This case poses the underlying problem as to who is the proper reporting entity (i.e., tax return) for reporting the recapture income resulting from the sale and purchase of [redacted] (target) under a section 338 election. That is, should the recapture income attributable to depreciation and investment credit recapture, resulting from the section 338 election, be reported on the selling group's consolidated tax return or on a separate "one day return" for [redacted] (the target), pursuant to Treas. Reg. § 1.338-1T. What is at stake here is that if [redacted] is required to include the recapture income in a separate "one day return", [redacted] will then no longer be able to benefit from the selling group's carryovers and carrybacks.

In early fall of 1982, Congress repealed § 334(b)(2) and enacted section 338. Under section 338 of TEFRA, the purchaser was permitted to make an election to treat a stock purchase of a target as a purchase of the assets of the target corporation. Under a section 334(b)(2) liquidation, recapture items were generally reportable on the purchaser's consolidated tax return. For the situation where the (old) target's final taxable year would have otherwise been included in a consolidated return of the selling group, the original section 338 provisions of TEFRA were not totally clear as to whether the liability for the recapture taxes was required to be reported on the seller's consolidated return. Yet, it was widely believed that a selling consolidated return group was liable for the recapture tax of a target generated by a section 338 election. To correct this misconception, Congress enacted section 306(a)(8)(A) of the 1982 Technical Correction Act ("TCA"). P.L. 97-448, 97th Cong. 2d Sess. (June 12, 1983). That provision provided that the items generated by the purchaser's section 338 election would constitute a separate one day return liability of the target corporation. See, Treas. Reg. § 1.338-1T(f)(3). Under that provision the purchaser would, in effect, bear the ultimate cost of the income taxes attributable to any recapture.

Yet, where the target corporation, prior to the transaction, had been a member of an affiliated group filing a consolidated tax return the Technical Correction Act provided through the enactment of, now, Code section 338(h)(10) that such target corporation could elect to be treated as a member of the selling consolidated group with respect to such sale, if that target corporation recognized gain or loss with respect to the transaction, as if it had sold all of its assets in a single transaction. 1/ The new section

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1/ This also entitled the selling consolidated group not to recognize any gain (or loss) on the target stock sold or exchanged in the transaction.

338(h)(10) election was made applicable only with respect to transactions in which the target company stock was acquired after January 12, 1983. Since the stock of [redacted] was acquired on [redacted], there appears to be no reasonable argument that the taxpayers had made a valid section 338 election.

Yet, notwithstanding the disaffiliation ("one day return") rule, Congress as part of the Technical Correction Act provided a special transitional rule for qualified stock purchases for which a "binding contract" of sale was entered into after September 2, 1982 (effective enactment date for section 338) but before January 13, 1983 (the effective date for making a section 338(h)(10) election). See, § 306(a)(8)(A)(ii) of the Technical Correction Act. That rule in effect provides that the target's deemed sale of assets can be reported in the selling group's consolidated return for the period including the acquisition date if:

> the purchasing corporation establishes by clear and convincing evidence that such contract was negotiated on the contemplation that, with respect to the deemed sale under section 338 of the Internal Revenue Code of 1954, the target corporation would be treated as a member of the affiliated group which includes the selling corporation.

That provision has been interpreted by Treas. Reg. § 1.338-IT(1)(1) to require that the purchasing corporation must establish "by clear and convincing evidence that the sales contract was negotiated on the contemplation that any tax liability resulting from the target's deemed section 338 sale would be reported in the selling group's consolidated return." (underlying supplied)

It is important to note that the above provision not only requires that it be contemplated by the parties that any tax liability resulting from the section 338 election would be reported on the selling group's consolidated return, but that the reporting of that liability effected the negotiated price between the parties. That is, the taxpayer to be entitled to rely on the "binding committment rule" must show by clear and convincing evidence that the parties had negotiated a purchase price based on the assumption that such tax liability would be reported on the selling group's consolidated tax return. The apparent purpose of the "binding committment rule" was to insure that where the parties had negotiated a sale price for the stock of the target based on the assumption that the selling group would be liable for certain tax liabilites of the target, it would be unfair if that tax liability were then imposed on the purchaser. That is, to impose such tax liability on the purchaser where the parties had already negotiated a purchase price for the stock based on the fact that

the selling group would be liable for the taxes would in effect require the purchaser to pay more than the bargained for price of the assets, which would result in an unjustified windfall to the seller. That is, it would serve to upset the actual price negotiated by the parties.

As to what is "clear and convincing evidence" for purposes of section 306(a)(8)(A)(ii) of the TCA and Treas. Reg. § 1.338-IT(1)(1)(i). Treas. Reg. § 1.338-IT(1)(2)(ii) provides, in part, that:

> In no event will the purchasing corporation be considered to have satisfied the clear and convincing requirement if the stock sale contract (or collateral documents) requires the purchasing corporation to indemnify the selling group for any federal income tax liability resulting from the deemed section 338 sale in the event that applicable law or regulations impose that liability on the selling group.

You seek our views as to whether the indemnification provision (the above paragraph) is valid as applied to the transaction here in question.

The indemnification provision is based on the notion that the hardship addressed by the "binding contract rule" does not exist if the seller will always avoid economic responsibility for the tax liability as a result of the contractual indemnification provision between the parties. That is, if the purchaser agrees to indemnify the seller in the event he later becomes obligated to pay the income taxes resulting from his section 338 election, then it cannot be said that the sales price agreed to by the parties was negotiated based on the assumption that the seller would have to report the income taxes resulting from the section 338 election. That is, whether the purchaser or the seller would have to report that tax liability would have no effect on the negotiated sales price, because in view of the indemnity agreement between the parties the purchaser would always bear the ultimate economic burden of paying the tax i.e., by direct tax liability or by indemnifying the seller for having paid that tax liability.

Accordingly, we believe that the indemnity provision of Treas. Reg. § 1.338-IT(1)(2)(ii) is a valid and rationale interpretation of section 306(a)(8)(A)(ii) of the 1982 TCA.

We note that it is not enough for the taxpayer to prove that the parties intended and expected the seller to be liable for reporting the additional taxes generated by the purchaser's section 338 election. The taxpayer must also prove that the stock purchase price was negotiated in reliance on the expectation that the seller would have to report such tax liability.

The taxpayer-seller will probably contend that inspite of the contractual indemnity provision it was very important to him who reported the recapture taxes, since only on the seller's consolidated return would offsets (like net operating loss carry forwards) be available from other corporations to reduce the resulting tax liability. The seller's asking price might have been influenced by the knowledge that he had net operating loss carryovers available to offset against any recapture income he might have to report. Yet, the availability of offsets would most likely not enter into the negotiations, since a purchaser who agrees to indemnify the seller for any taxes he will have to report in negotiating the stock purchase price will not be concerned by whether he or the seller will be required to report the recapture income. Furthermore, the wording of the binding committment rule as set forth in section 306(a)(8)(A)(ii) of the TCA of 1982 leaves no doubt that the "binding contract rule" can only be relied upon by the purchasing corporation, since the provision expressly requires that it is the purchaser who must provide the requisite evidence. As such we believe that Congress's only concern in enacting the "binding contract rule" was to ensure that the purchasing corporation would not be "saddled" with the tax burden for the additional taxes resulting from the section 338 election, which would in effect cause the purchaser to pay more than the bargained for price.

Admittedly, there may be a hardship to the selling group by not being able to utilize its NOL carryover against the recapture income. Still, we believe it is clear that Congress in enacting section 306(a)(8)(A)(ii) was not addressing that type of hardship and in any event was not addressing itself to any resulting hardship to the selling group. Such form of hardship was, however, covered by Congress in enacting section 338(h)(10). Yet, the quid pro quo for the offset privilege allowed by section 338(h)(10) is to tax all of a target's deemed sale gain to the seller without section 337 protection; whereas with respect to the application of the "binding contract" rule section 337 protection would still appear to apply.

Finally, an argument might me made for invalidating the indemnity provision of Treas. Reg. § 1.338-IT(1) on the ground that it is arbitrary and capricious because it applies the indemnity rule in situations where the purchaser agrees to indemnify the seller but does not apply an indemnity rule in the converse situation i.e., where the seller is to indemnify the purchaser. In the latter situation it can be noted that a hardship for the purchaser may exist inspite of the fact that the contract contains such an indemnification provision. That is, the purchaser can still have a hardship, because in the latter situation he may only be able to avoid the economic burden of the recapture tax liability by successfully enforcing the indemnity clause against the seller. Accordingly, it would be inappropriate for the Treasury to bar absolutely the application of the "binding contract" rule solely

because of the existence of a seller indemnity provision, since the hardship in question for the purchaser could still arise. Of course, in the latter situation in order to be entitled to avail himself of the benefits of the "binding contract rule" the purchaser will still have to prove by "clear and convincing evidence" that the sales contract was negotiated on the contemplation that any tax liability resulting from the target's deemed section 338 sale would be reported in the selling group's consolidated return.

Accordingly, we believe that Treas. Reg. § 1.338-IT(1)(2)(ii) is neither arbitrary nor capricious and is a valid interpretation of section 306(a)(8)(A)(ii) of the TCA. Moreover, it should be applied in the context of this case, and should thus prevent the taxpayers involved from availing themselves of the "binding contract rule". Accordingly, the section 338 deemed sale transaction in question should be reported in a one day "deemed sale return" of the target.

We turn now to what effect should be afforded to the subsequent agreement of [redacted]. The original contract, dated [redacted] contained the pertinent indemnification agreement wherein the purchaser agreed to indemnify the seller for any taxes which the seller might incur as a result of a deemed sale of assets, in the event the purchaser was to make a section 338 election. Unless the subsequent agreement operates to retroactively revoke or modify the original agreement, the supplemental agreement is not relevant to the issue under consideration, except possibly as an indication of the parties intent with respect to the original agreement. The transaction, (the actual stock purchase) was closed on [redacted]. On [redacted] purchaser, [redacted], and [redacted] (the newly-created subsidiary of [redacted]) filed an election under section 338 to have the purchase of the stock of [redacted] treated as an asset purchase. In view of the fact that both of the above events occurred prior to the "supplemental agreement" of [redacted], the supplemental agreement would appear to have no retroactive effect.

Yet, the issue of retroactivity would appear to turn on local contract law. As such, we advise you to research the pertinent local law on this point. We assume, however, for purposes of this memorandum that local law would not support such retroactivity. In any event, if the contents of the [redacted] supplemental agreement is considered an essential part of the agreement in toto, but without retroactive effect, then it could be concluded that there was no meeting of the minds--no binding contract--until [redacted]. Of course, if there was no binding contract until [redacted], then the binding contract rule would not be applicable to the instant transaction, because such rule is only applicable to

binding contracts entered into on or before January 12, 1983 (the date of the enactment of the TCA of 1982. In any event, characterizing the stock sale contract as not binding until [redacted], [redacted] appears to be unsupportable in view of the fact that the transaction (stock purchase) was closed on [redacted] and a supplemental agreement should not alter that fact.

We incorporate herein the memorandum dated July 2, 1986, submitted to this office by the Legislation and Regulations Division 2/ to provide further support for applying the indemnification rule of Treas. Reg. § 1.338-1(l)(2)(ii) to the facts of this case.

ROBERT P. RUWE

By: Alfred C. Bishop, Jr.
ALFRED C. BISHOP, JR.
Chief, Branch No. 2
Tax Litigation Division

Attachment:
Memo. dated July 2, 1986

2/ The conclusions of that memorandum appear to have been based on the assumption that the parties had negotiated the [redacted] contract with an understanding that the purchaser was going to make a section 338 election. The petitioners' attorney has confirmed the correctness of that assumption.